THE PAPER TRAIL

Proving a client is a sophisticated investor requires thorough documentation of your contact with him or her. By Ellen J. Bessner

In court, most complaining clients assert that they are unsophisticated and therefore did not understand the risks associated with their investments. But what criteria will a judge apply to determine if a client is sophisticated?

Is the criterion the client's accumulated wealth? Nope. A client may have accumulated wealth without being particularly sophisticated when it comes to investments. Is it his or her age? Not necessarily.

A judge will examine the following to determine whether or not a client is sophisticated:

Investment experience: What was the client's investment experience before the client opened an account with the advisor? Was the client's account at a bank with investments only in GICs and short-term deposits? Or did she have a discount account containing speculative investments?

Educational background: Did the client complete high school or university? Has the client ever taken investment courses or read books or business publications?

Vocation: What is the client's vocation? Is the client an accountant, a bookkeeper or a bank employee? Is the client a homemaker?

Understanding of risks: Did the client appear to or assert that he understood the risks? Did the client ask questions or make comments that led the advisor to believe the client understood the risks?

In court, the client usually asserts that he or she is unsophisticated and had no clear understanding of the types of investments in the account, the strategy employed or the risks associated with the account. The advisor usually asserts the opposite.

The judge will rely on the evidence both the client and the advisor present concerning what was explained to the client throughout the operation of the account, and the risks associated with each investment. But how does the judge determine if the client understood the risk and who is telling the truth?

Credibility, plausibility of the evidence

The judge will examine documentation such as account statements from the client's previous accounts and new client application forms from other institutions where the client had accounts. Did the advisor send any documentation to the client with a clear explanation of the risks? Did the advisor keep any notes of discussions he had with the client? Did the advisor write any letters to the client with an explanation of the risks and update the information? Did the client ask any questions or follow up with the advisor?

How can an advisor improve his chances that his testimony that the client was sufficiently sophisticated to understand the risks will be believed over the client's evidence?

❶ The advisor should take detailed notes during all meetings and telephone conversations with the client including any questions asked or comments made by the client.

❷ The advisor should point out (and preferably highlight or circle) the portions of the account agreements, the prospectus or other materials that outline the risks and send them to the client, while retaining copies for his or her own file.

❸ The advisor should document all of his or her contact with the client, by telephone or e-mail as the investment becomes more speculative or diminishes in value.

The risks an advisor takes by not keeping a paper trail are paramount. If the advisor has a paper trail, he or she is in a better position to prove the client had a clear understanding of the risks. Without a paper trail, the advisor is vulnerable to a client who asserts that he or she was too unsophisticated to understand the risks. This is particularly a problem if the client is a convincing and sympathetic witness. AE

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